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1-1-1991

In our opinion... , vol. 7 no. 2, June, 1991

American Institute of Certified Public Accountants. Auditing Standards Division

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Recommended Citation

American Institute of Certified Public Accountants. Auditing Standards Division, "In our opinion... , vol. 7 no. 2, June, 1991" (1991). *Newsletters*. 1302.

https://egrove.olemiss.edu/aicpa_news/1302

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In Our Opinion...

*The Newsletter of the AICPA Auditing Standards Division**

Volume 7 Number 2

June 1991

SAS NO. 65: CONSIDERING THE WORK OF INTERNAL AUDITORS

by Judith Sherinsky

Auditors generally agree that internal auditors's work provides an invaluable source of information about an entity and contributes to the efficiency of an audit; however, auditors do not always agree about the extent to which they may consider the work of internal auditors and still remain within professional guidelines. Determining how much consideration to give to work performed by internal auditors is a process that makes auditors uneasy because it entails taking responsibility for work performed by someone else. To provide expanded guidance to auditors on this issue, the Auditing Standards Board (ASB) recently issued Statement on Auditing Standards (SAS) No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

SAS No. 65, which is effective for audits of financial statements for periods ending after December 15, 1991, expands the guidance on considering the work of internal auditors presented in SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*, and supersedes that SAS. SAS No. 9 was written in 1975 and needed to be revised to reflect the terminology and concepts of the audit risk model and more recent SASs, particularly SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. The SAS also needed to be revised to reflect changes in the internal auditing profession and so a representative of the Institute of Internal Auditors was included on the task force that drafted SAS No. 65.

Roles of the Auditor and the Internal Auditor

The SAS defines and differentiates the roles of the auditor and the internal auditor by stating that the primary responsibility of the internal auditor is to provide evaluations and recommendations to management, while the primary responsibility of the auditor is to obtain the evidential matter needed to express an opinion on the financial statements. Internal auditors maintain objectivity with respect to the activity being audited; however, they are not independent of the entity in the same way that auditors are independent.

Internal Audit: Obtaining the Required Understanding

SAS No. 55 requires the auditor to obtain a sufficient understanding of the internal control structure to plan the audit. The internal audit function is part of the internal control structure, specifically part of the control environment; accordingly, the SAS presents sources of information and

appropriate inquiries for the auditor to make to obtain the required understanding. Examples of the information the auditor will need to ascertain about the internal audit function are whether there are limitations on the scope of internal audit's activities and to whom internal auditors report within the organization.

One of the first things the auditor needs to determine when obtaining an understanding of the internal audit function is whether the activities performed by internal audit are relevant to a financial statement audit. Some internal auditors focus on operational objectives such as compliance with federal hiring practices or the effectiveness of management's pricing decisions. These are worthwhile activities but they are not relevant to an audit of financial statements. If internal audit does not have financial-statement-related objectives, the auditor is not required to give further consideration to the work of internal auditors unless the auditor plans to have the internal auditors provide direct assistance. Direct assistance relates to work internal auditors perform at the request of the auditor to complete some aspect of the auditor's work program.

Even if internal audit's activities are relevant to a financial statement audit, it may be inefficient to use the work of internal auditors. Again, under those circumstances, the auditor is not required to give further consideration to the work of internal auditors, unless the auditor plans to have the internal auditors provide direct assistance.

If the auditor determines that internal audit's work satisfies the tests of "relevancy" and "efficiency," the auditor should then assess the competence and objectivity of the internal auditors. Factors such as education and professional experience should be considered in the evaluation of the competence of internal auditors. Assessments about the objectivity of internal auditors should include a determination of whether employment decisions related to internal auditors are made at a sufficiently high level in the organization to enable internal auditors to act without fear of retribution.

How may work performed by internal auditors affect the audit?

Work performed by internal auditors may affect the audit in three ways:

- (1) It may help the auditor to obtain an understanding of the internal control structure, as when the auditor

*The views expressed herein are those of the authors and do not necessarily reflect the views of the American Institute of Certified Public Accountants. Official positions of the AICPA are determined through certain specific committee procedures, due process, and deliberation.

CONSIDERING THE WORK OF INTERNAL AUDITORS (continued from page 1)

uses a narrative or flowchart prepared by internal auditors to obtain an understanding of how a system functions.

- (2) It may help the auditor to assess control risk, because internal auditors frequently perform tests of the operating effectiveness of internal control structure policies and procedures.
- (3) It may affect the substantive procedures the auditor ordinarily performs; if internal auditors confirm accounts receivable or observe inventories, the auditor may be able to consider the work performed by internal auditors and thereby reduce the number of confirmations sent or inventory locations observed.

What is the extent of the effect internal auditors' work may have on an audit?

Although internal auditors' work may affect the auditor's procedures, the responsibility to express an opinion on the financial statements rests solely with the auditor and cannot be shared with the internal auditors. Within that constraint, the SAS identifies the following factors to be considered when making judgments about the extent of the effect internal auditors' work may have on the audit:

- The materiality of the financial statement amounts.
- The risk (consisting of inherent risk and control risk) of material misstatement of the assertions related to the financial statement amounts.
- The degree of subjectivity involved in the evaluation of the audit evidence gathered in support of the assertion.

To put this guidance into perspective, consider an assertion about the valuation of loan loss reserves on the financial statements of a savings and loan association. Loan loss reserves are usually material to the financial statements of a savings and loan association. In addition, a high degree of

subjectivity is involved in the evaluation of audit evidence that supports such an assertion because, to a large extent, the assertion is judgment based. For such assertions, work performed entirely by internal auditors cannot alone reduce audit risk to an acceptable level. The risk and subjectivity associated with such assertions would require the auditor to perform a significant portion of the work.

On the other hand, if the auditor has assessed risk at a low level, as might occur for assertions about the existence of fixed assets, the auditor may decide, after considering work performed by internal auditors, that audit risk has been reduced to an acceptable level and that testing of the assertions directly by the auditor may not be necessary.

As the materiality of financial statement amounts increases and either the risk of material misstatement or the degree of subjectivity increases, the need for the auditor to perform his or her own tests of the assertions increases. As these factors decrease, the need for the auditor to perform his or her own tests of the assertions decreases.

During the exposure period of SAS No. 65, the Board received over 100 letters commenting on the exposure draft. About 50% of the letters received were from internal auditors, many of which expressed dissatisfaction with the tone of the document and a belief that the proposed SAS inappropriately minimized the role of internal auditors in the audit. In contrast, letters from external auditors commonly expressed concern that the SAS might encourage overreliance on the work of internal auditors. In drafting the final SAS, the Board sought to strike an appropriate balance between these two views.

Since the SAS is effective for audits of financial statements for periods ending after December 15, 1991, auditors of entities with calendar year ends will soon be applying the guidance in this SAS. Although auditors will always need to exercise professional judgment when making decisions about consideration of work performed by internal auditors, the expanded guidance in SAS No. 65 should take some of the uncertainty out of the process.

AUDIT RISK ALERT CONFERENCE PLANNED

The AICPA is planning its first annual audit risk alert conference based on its newly expanded series of audit risk alerts to heighten auditors' awareness of areas of audit risk. The conference will contain sessions of general interest regarding audit risk that would affect most 1991 year-end audits and of specific interest to auditors of clients in specialized industries.

The conference will be presented in five cities throughout the U.S. in November and December in order to be useful in planning calendar year-end audits. Like the audit risk alert

series, the conference will be designed to provide auditors with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

The conference will feature nationally-renowned speakers and break-out sessions in nearly all industries covered by existing audit and accounting guides. The recommended number of continuing professional education credits will be 8 hours.

TECHNICAL PLAN HIGHLIGHTS

Audit Sampling (AICPA Staff: DOUG SAUTER). The task force is revising the Audit Sampling Guide for conforming changes made to SAS No. 39. Also, the task force plans to provide additional guidance to address practice problems related to the implementation of SAS No. 39. **Schedule:** The task force plans to issue an exposure draft of a revised guide in the fourth quarter of 1991.

Auditing Insurance Entities' Loss Reserves (JUDITH SHERINSKY). The task force is drafting a Statement of Position

(SOP) that will supplement the Audit and Accounting Guide, *Auditing Property and Liability Insurance Companies*. The SOP will provide guidance to auditors on developing an effective approach when auditing the claim loss reserves of insurance companies. In April 1991, the task force presented several issues to the Audit Issues Task Force (AITF) and is currently revising the draft to reflect recommendations made by the AITF. **Schedule:** An exposure draft of the proposed SOP will be issued in the third quarter of 1991.

TECHNICAL PLAN HIGHLIGHTS

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Audits of Small Businesses (DOUG SAUTER). The auditing procedures study *Audits of Small Businesses* is being revised to reflect SAS Nos. 53-62. The chapters on evaluating internal controls and on performing analytical procedures will be revised to discuss the implementation of SAS Nos. 55 and 56, *Consideration of the Internal Control Structure in a Financial Statement Audit* and *Analytical Procedures*, respectively, in small business audits. Other changes will be made throughout the study to provide guidance that is consistent with the standards. **Schedule:** The revised auditing procedure study will be available in the fourth quarter of 1991.

Compliance Attestation Guidance (WALT CONN). The Board has formed a task force to develop a "generic" attestation standard on testing and reporting on compliance requirements, including testing and reporting on controls over compliance requirements. It is expected that this standard will build upon Statement on Standards for Attestation Engagements, *Attestation Standards*. **Schedule:** The task force will meet in the second quarter to discuss existing guidance and to determine whether such guidance should be included in a proposed standard.

Computer Auditing (JANE MANCINO). The Computer Auditing Subcommittee is currently drafting three auditing procedure studies. One describes how SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, can be implemented in a computer environment. The second addresses the possible effects of advanced EDP systems on the auditor's consideration of an entity's internal control structure. The third updates the guidance in the Audit and Accounting Guide, *Computer Assisted Audit Techniques*. **Schedule:** The first study is expected to be published during the third quarter of 1991. The second study should be published in the fourth quarter of 1991 and the third study in 1992.

Consideration of Internal Auditors' Work (JUDITH SHERINSKY). As described in the article on page 1, the ASB issued SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* in April 1991.

Financial Forecasts and Projections. The Board created a task force to deal with problems encountered in implementing the guidance in the Statement on Standards for Accountant's Services on Prospective Financial Information. An exposure draft of a statement of position (SOP) titled *Questions and Answers on Reasonably Objective Basis and Other Questions Affecting Prospective Financial Statements* was issued in February 1990. The SOP would provide guidance to practitioners on the meaning of the term "reasonably objective basis" as used in the *Guide for Prospective Financial Statements* (the Guide). The task force also is preparing a new codification of the Guide that will include all the SOP's issued since its publication in 1986. **Schedule:** The final SOP is expected to be available in the third quarter of 1991. The new guide is scheduled to be available by the end of 1991.

GAAP Hierarchy (DOUG SAUTER). The Board created a task force to consider recommendations of the Financial Accounting Foundation to revise the hierarchy of GAAP included in AU Section 411, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report*. **Schedule:** The Board plans to issue an exposure draft of proposed revisions to the hierarchy in the second quarter of 1991.

Letters for Underwriters (JANE MANCINO). An exposure draft of a proposed SAS was issued on May 10, 1991. The proposed SAS would revise SAS No. 49 to reflect certain changes in SEC requirements and to conform with current professional standards. **Schedule:** The comment period will end July 10, 1991.

Reporting on Internal Controls. The Board is developing performance and reporting guidance for a practitioner engaged to examine and report on management's assertions about the effectiveness of the entity's internal control structure. **Schedule:** The Board plans to expose a proposed statement on standards for attestation engagements, *Reporting on Management's Report on the Effectiveness of an Entity's Internal Control Structure Over Financial Reporting*, in the third quarter of 1991.

Review of Interim Financial Information (JANE MANCINO). The Board voted unanimously for balloting to determine whether this proposed SAS should be issued as an exposure draft. The draft (1) provides guidance on the knowledge of internal control structure policies and procedures that the accountant needs to obtain when engaged to perform a review and the accountant has not audited the most recent annual financial statements and (2) adds to the review report a statement of management's responsibility for the interim financial information. **Schedule:** The exposure draft is expected to be available in the second quarter of 1991.

SAS No. 54 Guidance (WALT CONN). The Board has formed a task force to address various issues relating to the auditor's responsibility for detecting and reporting illegal acts. Such issues include guidance being developed internationally about illegal acts. **Schedule:** In June, the task force plans to consider the direction of the project and to meet with a Public Oversight Board representative to discuss that Board's recommendation that auditors assume increased responsibility for evaluating and reporting management abuses of corporate assets.

SAS No. 63 Implementation (DOUG SAUTER). The Board has a project to review certain technical issues related to SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance*. The Board has issued an exposure draft of a proposed SAS that would revise SAS No. 63 to require a compliance report on general requirements in all single audits and note that certain guidance in SAS No. 63 applies to audits of nonprofit organizations conducted in accordance with OMB Circular A-133. **Schedule:** The exposure draft of a proposed SAS was issued April 9, 1991. The comment period will end July 1, 1991.

Service-Center-Produced Records (JUDITH SHERINSKY). In February, 1991 the ASB issued an exposure draft of a proposed SAS titled, *Reports on the Processing of Transactions by Service Organizations*. The proposed SAS provides

TECHNICAL PLAN HIGHLIGHTS

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guidance to practitioners engaged to audit the financial statements of an entity that uses a service organization in connection with the processing of transactions. Examples of such service organizations are EDP service centers and bank trust departments that invest and hold assets for employee pension plans. The document incorporates the terminology and concepts of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, and will supersede SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*. The comment period ends on May 27, 1991. **Schedule:** The task

force will present a summary of the comment letters at the August 1991 ASB meeting.

Use of Confirmations (DOUG SAUTER). The Board created a task force to develop guidance on the use of all types of confirmation procedures in audit engagements. The Board issued an exposure draft of a proposed statement in November 1990. Among other matters, the exposure draft discusses the relationship of confirmation procedures to audit risk and financial statement assertions, and describes certain factors that affect the reliability of confirmations. **Schedule:** The comment deadline for the exposure draft was February 1, 1991. The task force is considering the 85 comment letters received and plans to present a revised proposed statement to the Board in June 1991.

ACCOUNTING AND REVIEW SERVICES COMMITTEE

The Accounting and Review Services Committee (ARSC) met in April and tentatively agreed to amend the language of the SSARS review report to state that a review was performed in accordance with "Statements on Standards for Accounting and Review Services established by the AICPA." The SSARS review report currently states that a review was performed in accordance with "standards established by the AICPA." ARSC proposed this change to help differentiate a SSARS review report from a SAS No. 36 review report. Communication requirements that will be added to SAS No. 36, *Review of Interim Financial Information*, as part of the revision of that SAS, will create a significant difference between a SSARS

and a SAS review engagement. The similarity between the two reports could cause financial statement users to incorrectly assume that the standards for both engagements are the same. In addition, ARSC issued the following interpretations:

- An interpretation of SSARS 6, *Reporting on Personal Financial Statements Included in a Written Personal Financial Plan*, that interprets developing personal financial goals and objectives to include implementation of the financial plan by the client or the client's advisers.
- An interpretation of SSARS 1, *Compilation and Review of Financial Statements*, that clarifies the applicability of that standard to litigation service engagements.

RECENT PUBLICATIONS

Omnibus Statement on Auditing Standards—1990. In December 1990, the Board issued SAS No. 64, *Omnibus Statement on Auditing Standards*. This SAS (1) requires the use of the terms "substantial doubt" and "going concern" in an explanatory paragraph when the auditor has substantial doubt about the entity's ability to continue as a going concern; (2) changes the language in the auditor's report to describe the level of service performed when prior-period financial statements, which have been reported on by other auditors, are restated.

Communication About Interim Financial Information. The Board has agreed to issue a SAS that would establish requirements for the auditor to communicate certain matters affecting interim financial information filed or to be filed with specified regulatory agencies. SAS No. 66 will be available in June 1991.

Industry Audit Risk Alerts. Audit Risk Alerts for three industries (nonprofit organizations, employee benefit plans and state and local governmental units) will be issued during the second quarter of 1991 to remind practitioners of matters that affect audit risk in those industry. (Sixteen other Audit Risk Alerts were published in late December and early January. Industries covered in those included agribusiness, airlines, banks, casinos, construction contractors, credit

unions, federal government contractors, financial companies, health care, investment companies, life and health insurance companies, oil and gas producers, property and liability insurance companies, saving and loan associations and securities brokers and dealers.) The series also includes a general audit risk alert applicable to virtually all audited entities.

Audit and Accounting Guides. The AICPA recently issued Audits of Property and Liability Insurance Companies, which supercedes the 1966 AICPA Industry Audit Guide, *Audits of Fire and Casualty Insurance Companies*. Also, the AICPA plans to publish the following audit and accounting guides in the second quarter: *Audits of Savings Institutions*, *Common Interest Realty Associations*, and *Audits of Employee Benefit Plans*.

Loose-leaf Guide Service. The AICPA has entered into a contract with Commerce Clearance House for the publication of a two-volume loose-leaf service comprising all of the Institute's audit and accounting guides and industry audit risk alerts. The initial version of the service was published in January 1991. The objective of the loose-leaf service is to provide a mechanism for updating the guides for specific issues on a timely basis. Until now, updates have been accomplished through revised editions of entire guides and the issuance of statements of position.

In Our Opinion is published by the
Auditing Standards Division
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Editor:
Douglas P. Sauter
Administrative Editor:
Lori Fareri